

THE ROLE OF EMPLOYER-SPONSORED RETIREMENT PLANS AND NATIONAL SAVING

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*Eugene Steuerle**
Senior Fellow
The Urban Institute

*Eugene Steuerle is a Senior Fellow at the Urban Institute and a former Deputy Assistant Secretary of the Treasury. He also serves currently on the Advisory Board for the Retirement Security Project sponsored by the Pew Charitable Trusts, as well as an advisor to the Conversation on Coverage, convened by the Pension Rights Center, co-sponsored by a host of other organizations, including the Urban Institute, and supported in part by the Ford Foundation and the W.K. Kellogg Foundation. Part of his testimony is taken from research with Elizabeth Bell, Adam Carasso, and Richard Johnson and as part of a broader project on Opportunity and Ownership and supported in part by the Annie E. Casey Foundation. All views expressed in this testimony are his and do not necessarily reflect those of the Urban Institute, its board, its trustees, or any of the individuals in the organizations above.

Mr. Chairman and Members of the Committee:

It is a privilege to join you again today and to discuss the role of employer-sponsored retirement plans in national saving. On the positive side, the United States is in a select group of developed nations with a significant share of its assets in pension and retirement accounts, largely employer sponsored. The involvement of employers appears to be crucial to increasing retirement assets, whether the employer directly funds these accounts or merely makes them available to employees.

The evidence that retirement and pension incentives have done much recently for national saving, however, is weak. Total personal saving in the United States is now below the annual revenues spent in supporting retirement and pension plans. Even that comparison does not even count the revenues used to support other saving incentives, such as for education or health. Even if net saving were not an issue, the distribution of retirement saving is highly skewed, and the current system fails to provide much in the way of retirement saving not just for those with low-income, but for a substantial majority of the population.

One major reason is that all of these government subsidies are for *deposits* (whether by employees or employers), not saving, and there is a big difference. A second is that the extraordinary complexity of the laws surrounding employee benefits discourages some employers from participating, and the related costs absorb a significant share of the returns to saving. Some pension designs and laws also present an assortment of problems that probably also reduce saving: easy withdrawal before very old age, traditional defined benefit plan designs that often discriminate against older workers, and a threat of lawsuits (from tax, labor, and age discrimination statutes) that raise employer costs for providing retirement benefits. Yet another negative influence on saving is that most people now retire in late middle-age with one-third of their adult lives remaining before them—moving into spend-down patterns in years where traditionally saving rates tend to be high. Finally, the incentives provided to low- and moderate-income households often are also fairly small and sometimes non-existent.

There are various ways to try to deal with these issues. One is limiting tax breaks for those who are “arbitraging” the tax system by applying limitations on their interest deductions when they are receiving tax-deferred interest or other capital income in retirement accounts. Tightening up on withdrawals from retirement plans before old age could also enhance saving. Another approach is to simplify, even at the cost of removing some preferences for some people. Strong consideration should be given to creating “safe harbors” for employers in designing retirement plans for older workers, including those seeking bridge jobs rather than full retirement. Another promising approach is to promote policies that allow employers to set defaults for employee deposits from which employees can opt out, rather than using defaults of zero deposits to which they must opt in. Another strong possibility is to increase the subsidy for lower- and moderate-income taxpayers. The savers credit serves as an example, although it has three major limitations: it is small or does not apply for most low- and moderate-income households; it does not cover employer deposits; and the tax subsidy itself does not go into retirement accounts. A clearinghouse may be necessary to handle rollovers out of employer plans and a simplified saving system, especially when small amounts are involved. Finally, mandates that employees save for retirement, including through employer-sponsored plans, should be considered as one leg of a broader retirement stool.

The rest of my testimony elaborates on these points.

Aggregate Level of Retirement Assets

Households in the United States hold close to one-fourth of their net worth in retirement assets of one type or another—largely employer-sponsored retirement accounts. According to data compiled by the Federal Reserve Board, over \$11 trillion are now held in pensions and retirement accounts. The United States is among an elite group of industrial nations in terms of its level of funding of pension plans. Some countries have relied more upon unfunded private pension plans, and this has become a grave concern as their populations age. Imagine, if you will, our own very serious Pension Benefit Guarantee Corporation problem multiplied several-fold, and you get some idea of the problems facing some other nations.

The employer plays a crucial role in encouraging retirement saving. Perhaps the strongest proof comes from comparing participation rates in employer-sponsored plans with participation rates in Individual Retirement Accounts (IRAs). Each year significantly less than 10 percent of the eligible population voluntarily puts money into IRAs, but participation in employer-sponsored plans is often 50 percent or higher—even when the employee is responsible for making the contribution. The simplicity of automatic payroll deductions and the involvement of employers as intermediaries in explaining and encouraging plan participation are clearly important factors in savings rates.

Lack of Net Saving

Still, net saving by households is quite small. In fact, total personal saving by households is now below the annual revenue cost of subsidizing retirement and pension plans (see Figure 1). Although both measures—retirement saving incentives and personal saving—have limitations (e.g. personal saving does not count investment in owner-occupied housing), the comparison reveals how little net saving these incentives are creating. It appears that efforts over the past few decades to stimulate private saving by providing numerous tax incentives for contributions to pension plans and retirement accounts have limited success in raising overall private saving. Given the revenue costs involved, these efforts have been even less successful in raising national saving, or the sum of private and public saving.

Trends in Pension Savings: Participation and Accumulation

For most households, pension saving covers only a modest portion of total retirement needs. For almost two-thirds of households approaching retirement, the lifetime value of their future Social Security and Medicare benefits (that is, the lump sum value as if in a 401(k) plan near to time of retirement) is greater than the sum of all their private assets: retirement plans, housing, and other private saving combined (Figure 2). Even excluding Medicare, Social Security by itself comprises over one-half of retirement wealth for most households.

When examined in terms of cash income (which excludes Medicare and rent saving from homeownership), Social Security benefits are the largest source, providing 50 percent or more of retirement income for 65 percent of beneficiaries.¹ While the vast majority of workers are

¹ Income of the Aged Chart Book, 2001, Washington, DC: The Social Security Administration.

covered by Social Security (91 percent), almost half of all full-time workers do not currently participate in a pension plan and, more crucially, 12 percent who do not participate are 55 to 64 years old.

Figure 3 shows the aggregate shares of different sources of retirement income that go to the 65 and over population, for the poorest (first), third, and richest (fifth) income quintiles. Social Security is clearly the mainstay of retirement for low-income families with the next largest contribution coming from public assistance. Only those in the top quintile rely substantially upon pension and retirement plans; they enjoy a much more balanced distribution of income sources in retirement, with earnings from employment supplying 35.2 percent, and then roughly similar shares (18-25 percent each) of income supplied by private and government pensions, other assets, and Social Security. Even the middle-income quintile of retirees receives only about 16 percent of income from pensions.

Table 1 characterizes full-time and part-time employees with no employer-sponsored retirement plan in 2003. Among full-time workers who had access to an employer plan, nearly 72 percent of the bottom income quartile failed to participate, compared to 28 percent in the top quartile. Along with income, firm size is another predictor of employee participation, with much higher percentages of workers at smaller firms (73 percent) failing to participate than at larger firms (32 percent).

Not unexpectedly, research shows markedly different retirement savings outcomes based on worker demographic characteristics, such as race, education, and marriage. For instance,

- A higher level of educational attainment leads to a higher likelihood of having an employer-sponsored pension plan; having a high school diploma or its equivalent raises this likelihood by nearly twenty percentage points;
- Married workers enjoy a higher percentage of pension participation than unmarried individuals;
- A very high percentage of Hispanics do not have pension plans;
- Smaller firms are often reluctant or unable to accept the fiduciary responsibility and administrative costs that accompany employer-sponsored plans, while low-income workers are both more likely to work for such firms and to have a high turnover rate.
- Part-time workers have much lower participation rates. Individuals in the bottom earnings quartile are among those most likely to be employed at smaller firms, and such firms have a drastically lower share of employees participating.

Figure 4 shows the accumulation of retirement savings, other than defined benefit pension plans, by age for persons at the 50th (median), 70th and 90th percentiles of income. The chart plots a trendline through data points at each age, expressing the amount of savings in multiples of the Social Security average wage, which was about \$35,000 in 2004. At the 50th percentile and at the peak ages of asset accumulation (between ages 50 and 60), the balance of retirement accounts never reaches more than three-quarters of the average wage--or about \$27,000 in 2004. Even at the 70th percentile, the accumulation peaks at about two times the average wage--or about \$70,000. Only the top 10 percent of households have retirement saving equivalent to about eight times the average wage. Clearly, only the highest income groups have much in the way of retirement saving to tap into at retirement.

Some Explanations for the Low Saving Rate

5. *Subsidies for Deposits, not for Saving*

Although an argument can be made that today individuals save less than their parents, in point of fact they (or at least the richer among today's workers) are making substantial *deposits* to retirement and pension plans. Therefore, we must dig a little deeper. The main distinction with the past is that households are borrowing at much higher level to finance consumption. When deposits are borrowed for consumption, there is no increase in saving or investment in the economy.

Now think about so-called retirement saving incentives. Part of the problem is that these incentives do not really subsidize saving, which requires a reduction in consumption spending and current living standards to finance investment. Instead, they merely subsidize deposits or contributions, whether by employer or employee, into a pension plan or retirement account. These contributions can be made in many "painless" ways that do not involve reducing one's standard of living. High-income, high-wealth households are best able to make such painless contributions, drawing from income they would have saved anyway, assets they have already saved, or borrowed money. Note that depositors don't have to think about this process. They may one day deposit more money to a 401(k) plan or accept lower wages because their employer makes such a contribution. The next year they may take out a second mortgage, without making any connection between the two events. Many other pension deposits increase the funds lent to other individuals on their credit cards.

2. *Complexity of Plans*

I have been working in this policy arena since the mid-1970s, and not a year has gone by when some new saving proposal has not been proposed in Congress. A very large number have been enacted. Today, the array of retirement plan options (not to mention other saving incentives) is extraordinary in number (see Figure 5). Each has rules, often different, with regard to deposits, withdrawals, loans, penalties, income taxability, Social Security taxability, age restrictions, vesting, and a whole range of other issues. I have yet to meet any pension lawyer, much less employee benefit expert, who understands them all.

All of this costs money. Many employers no longer want to absorb these costs. In the end, most are borne by employees. These costs not only reduce employer offerings, but they likely reduce the net return available to employees even when plans are offered. Moreover, many firms producing particular goods or services do not want to be responsible for assets of employees who have long left the firm, or to handle issues of divorce, separation, and other household rearrangements that may affect ownership rights to those assets. Many employers simply do not want that level of fiduciary responsibility, even though many are quite content to make deposits on behalf of employees.

3. *Pension and Retirement Plan Design*

A number of issues arise in the ways that retirement plans are now constructed. Defined contribution plans like 401 (k) plans can be spent down quickly at retirement since few

individuals take those benefits in the form of an annuity. When employees change jobs, they are likely to withdraw money from both defined contribution and defined benefit plans, which often provide lump sum values at time of transition. Traditional defined benefit plans typically discriminate against both old and young workers by giving them little in the way of benefits relative to middle-age workers. For some older workers, the pension benefit—defined as economic accrual—is actually negative, encouraging them to retire and draw down assets rather than to continue to work and save (see Figure 6). By the way, the government’s own Federal Employees Retirement System (FERS) has these same negative features for older workers. Meanwhile, employers hiring or retaining older workers, if they are not careful, run the risk of getting sued under ERISA labor law, tax law, and laws on age discrimination. Thus, employers have difficulty constructing reasonable retirement plan options for workers in their 60s and 70s—an age group quickly becoming the largest underutilized pool of human resources in the economy.

4. Retirement in Prime Saving Years

People now retire in middle age. In 1940, the average worker retired at age 68 with about 11 years of life expectancy. Today, if the typical worker were to retire for the same number of expected years of life, he or she would be retiring at about age 74. By about 2065, he or she would retire at about age 78. Instead, the typical worker retires today at age 63, and employer plans—partly following the law—provide benefits to people when they are still in middle age, at least as defined by life expectancy. At first you may think this is a labor force, not a saving, issue. But, in fact, people are retiring in years when traditionally they were very likely to be significant savers. Instead of being net savers, they turn into dis-savers, drawing down instead of building up assets. This adds to the decline in national saving both because there is less output from the smaller labor force and because a larger proportion of output is being consumed.

5. Limited Subsidies for Low- and Moderate-Income Households

Our system of government subsidies for retirement contains limited support for low- and moderate-income households. A person in a low- or zero-tax bracket has little tax incentive to save. The savers credit in the current law contains maximum amounts for which almost no one is eligible because it is nonrefundable and is already phasing down as income increases to the point that taxpayers start paying enough taxes to be eligible for a refund.

Policy Options

There are a variety of retirement options associated with employer-sponsored plans that Congress ought to consider trying to increase the saving rate in the economy. A related goal—one that is prudential even if net saving does not increase—is to try to increase the level of retirement saving for most low- and middle-income Americans. Here are some possibilities.

First, there need to be greater restrictions on subsidies for deposits that aren’t leading to net saving and on early withdrawals of deposits that aren’t saved to cover needs in old age. Among the tougher standards here would be limits on interest deductions to the extent that retirement income is excluded from tax (this would require current information reporting from retirement plans). Congress should also consider tighter limits on withdrawals from retirement plans, whether on the job, at time of transition to a new job, or even early in retirement years. As

noted, these withdrawals increase the likelihood that households will have few assets available if they live to a ripe old age.

Second, simplification is long overdue. The transition from a world of dozens of choices is not easy, but required.

Third, pensions and retirement plans need to be designed around the needs of workers and employers today, not those of the 1950s. Simple safe harbors in retirement plan design are necessary for employers hiring or retaining older workers. I expect their numbers to increase substantially in the future, and we need laws to accommodate these changes. The constant threat of lawsuits needs to be greatly reduced.² The age limits specified in the laws are outdated. People are living much longer, for instance, so various age requirements—such as required withdrawals beginning close to age 70—need to be adjusted upward.

Fourth, there is strong evidence that participation rates in employer plans would increase significantly if more employers would automatically enroll employees unless they chose to opt out. A closely related opportunity is to automatically increase the contribution rate of employees as they get raises—again, unless they opt out. A Retirement Security Project has these items very high on their list of issues to pursue, and many conservatives and liberals both seem to be in agreement as to the potential gains. Although such options are probably legal now, clarification by Congress could help prevent the threat of future lawsuits.

Fifth, we need to figure out better ways of providing incentives to low-, moderate-, and even middle-income taxpayers. Expanding the savers credit and making it permanent is one option, but, as noted, it has three major limitations. Strong consideration should be given to figuring out how to deal with making the credit refundable, applying the credit to employer deposits, and keeping the subsidies in retirement accounts.

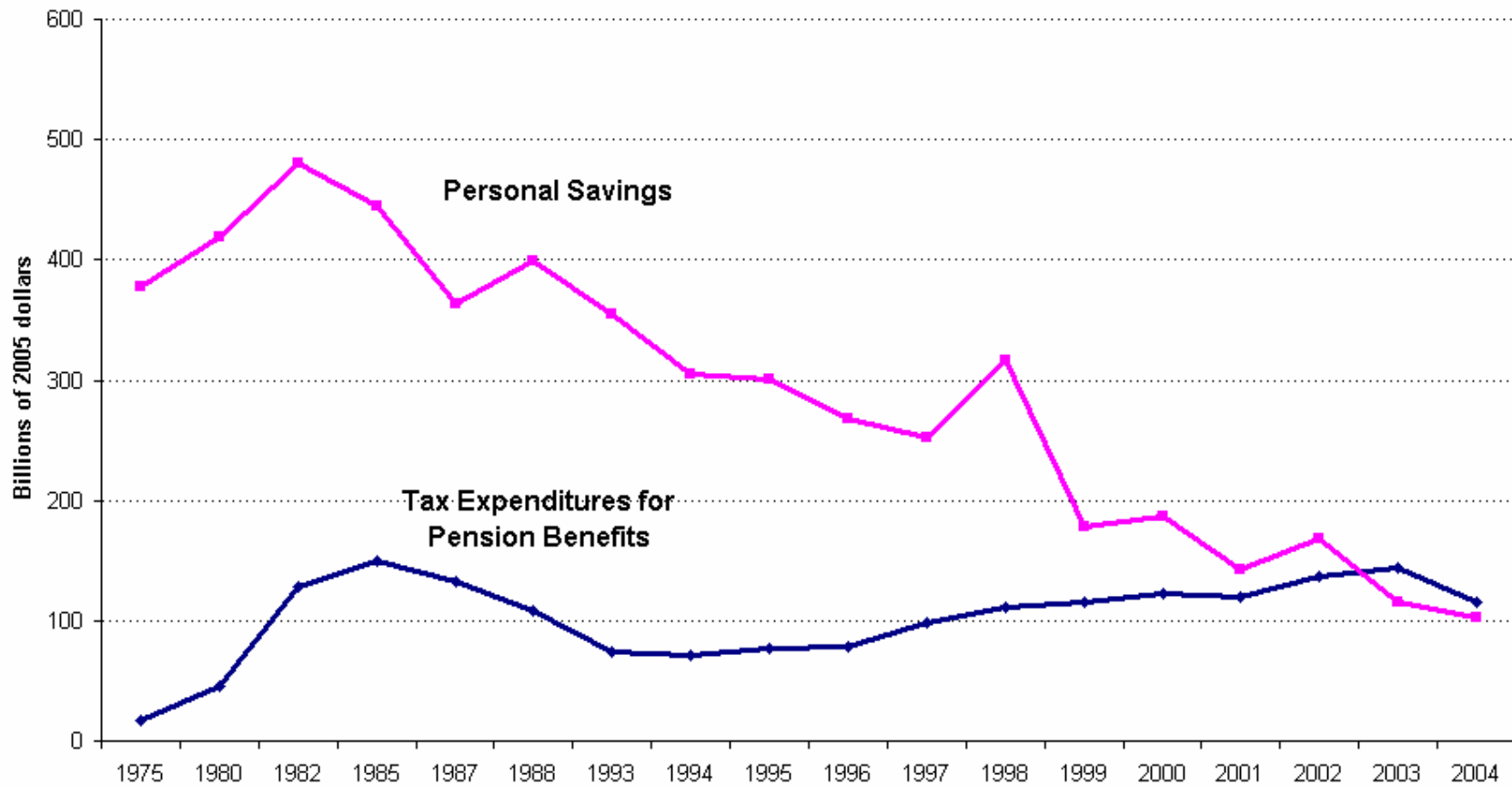
A sixth area of investigation is to attenuate employer worries over the costs and fiduciary responsibilities of retirement plans—especially for departed employees and for small amounts—by providing a clearinghouse that could help with the collection of rollover amounts, default rules for the management of investments, and the disbursement of benefit payments over time rather than all at once.

Finally, mandated saving by employees is on the table as a Social Security issue, but it needs separately to be brought into the debate over employer-provided pensions and other private retirement arrangements.

² As a technical matter, the law also needs to make clear that for almost all purposes (often related to measuring discrimination), accrual means economic accrual, not the attainment of a higher annual benefit even when the present value of benefits is reduced.

FIGURE 1

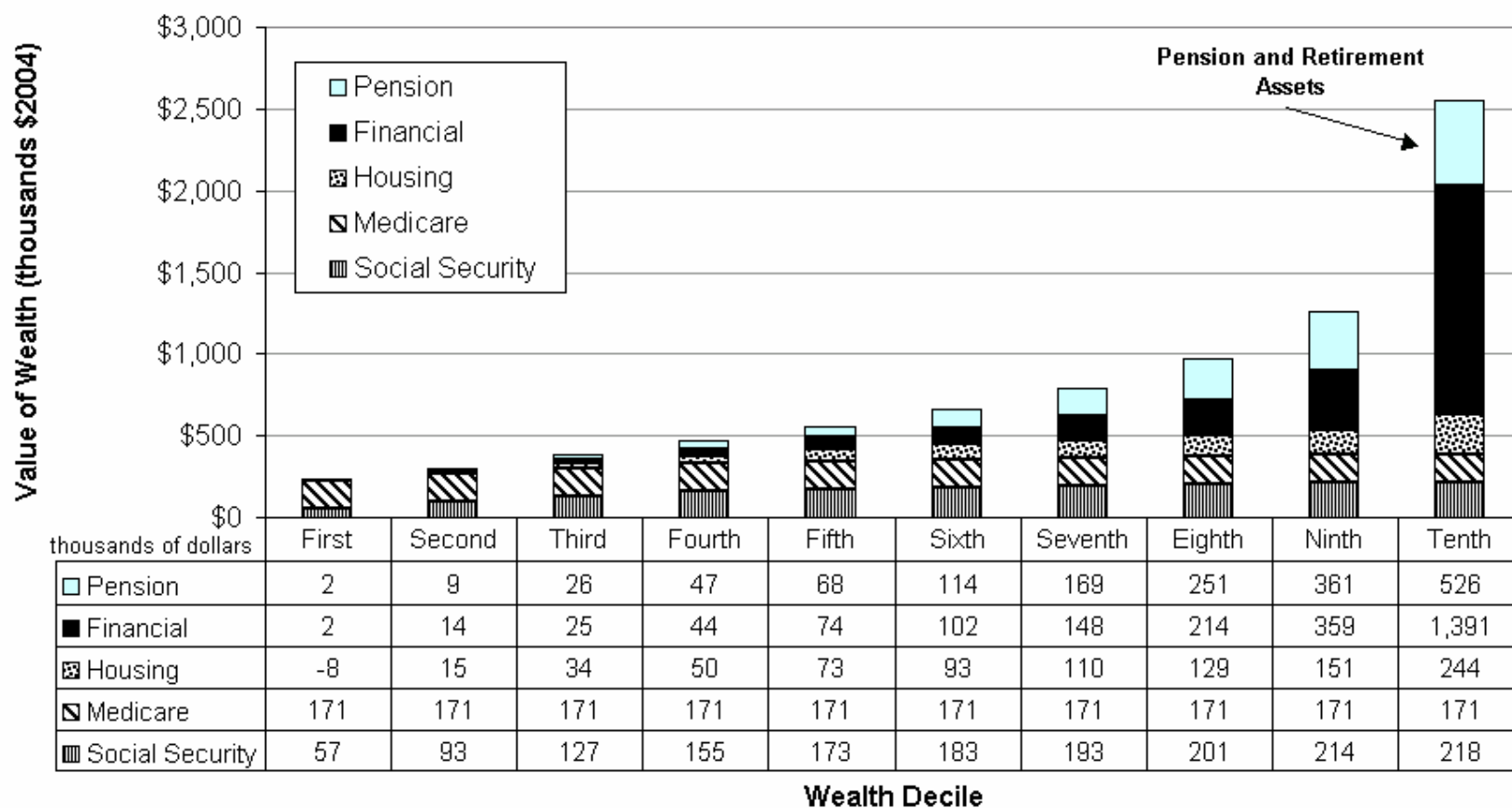
Retirement Savings Incentives Versus Personal Savings, 1975-2004



Note: Tax expenditures are not strictly additive. The cash flow measures above do not reflect the present value of pension subsidies.
Source: The Urban Institute, 2005. Based on data from the Office of Management and Budget, Analytical Perspectives (prior to 1990, Special Analyses), Budget of the United States Government, various years. Personal savings data from the Board of Governors of the Federal Reserve, 2005.

FIGURE 2

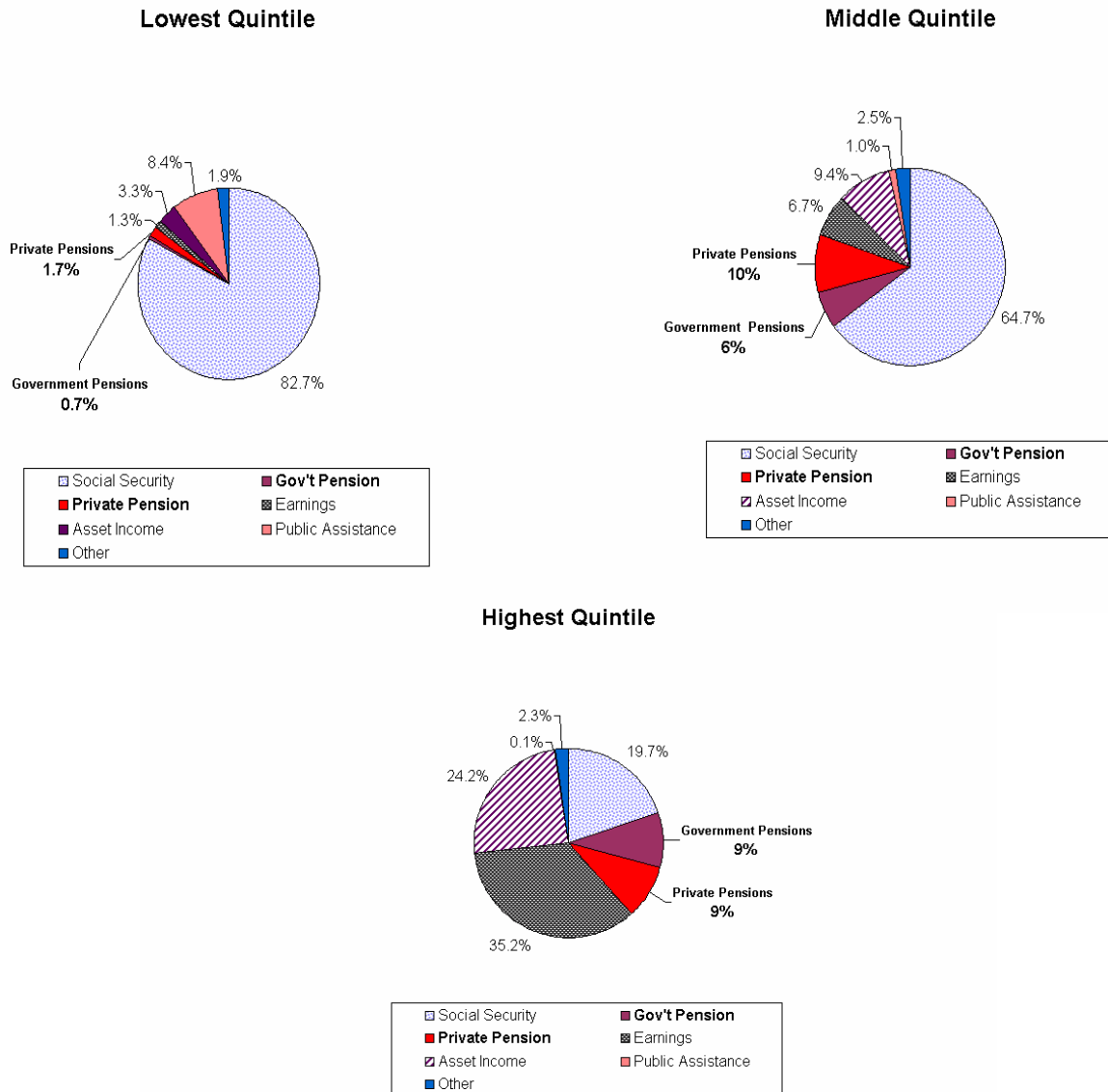
Mean Value and Composition of Household Wealth, Ages 51-61, by Wealth Decile



Note: Private pension, Social Security, other financial, and housing wealth data come from Moore and Mitchell (2000), based on a sample of households from the Health and Retirement Survey in which at least one member was aged 51-61 in 1992. Medicare wealth is from Steuerle and Carasso (2004). Source: Moore, James F., and Olivia S. Mitchell. 2000. "Projected Retirement Wealth and Savings Adequacy." In *Forecasting Retirement Needs and Retirement Wealth*, edited by O.S. Mitchell, P.B. Hammond, and A.M. Rappaport. Philadelphia: Univ. of Pennsylvania Press; C. Eugene Steuerle, and Adam Carasso. 2004. "The USA Today Lifetime Social Security and Medicare Benefits Calculator: Assumptions and Methods." Washington, DC: The Urban Institute.

FIGURE 3

Composition of Income in Retirement for Aged Units 65 and Over



Note: Quintile limits are as follows for all units: First quintile: \$0-\$9,295; Second quintile: \$2,296-\$14,980; Third quintile: \$14,981-\$23,631; Fourth quintile: \$23,632-\$39,719; Fifth quintile: >\$39,719. Social Security includes Railroad Retirement.

Source: The Urban Institute, 2004. Based on data from the Income of the Aged Chartbook, 2001, Washington, DC: Social Security Administration, February, 2002, Table 7.5.

TABLE 1

Characteristics of Workers without Pension Plans, 2003

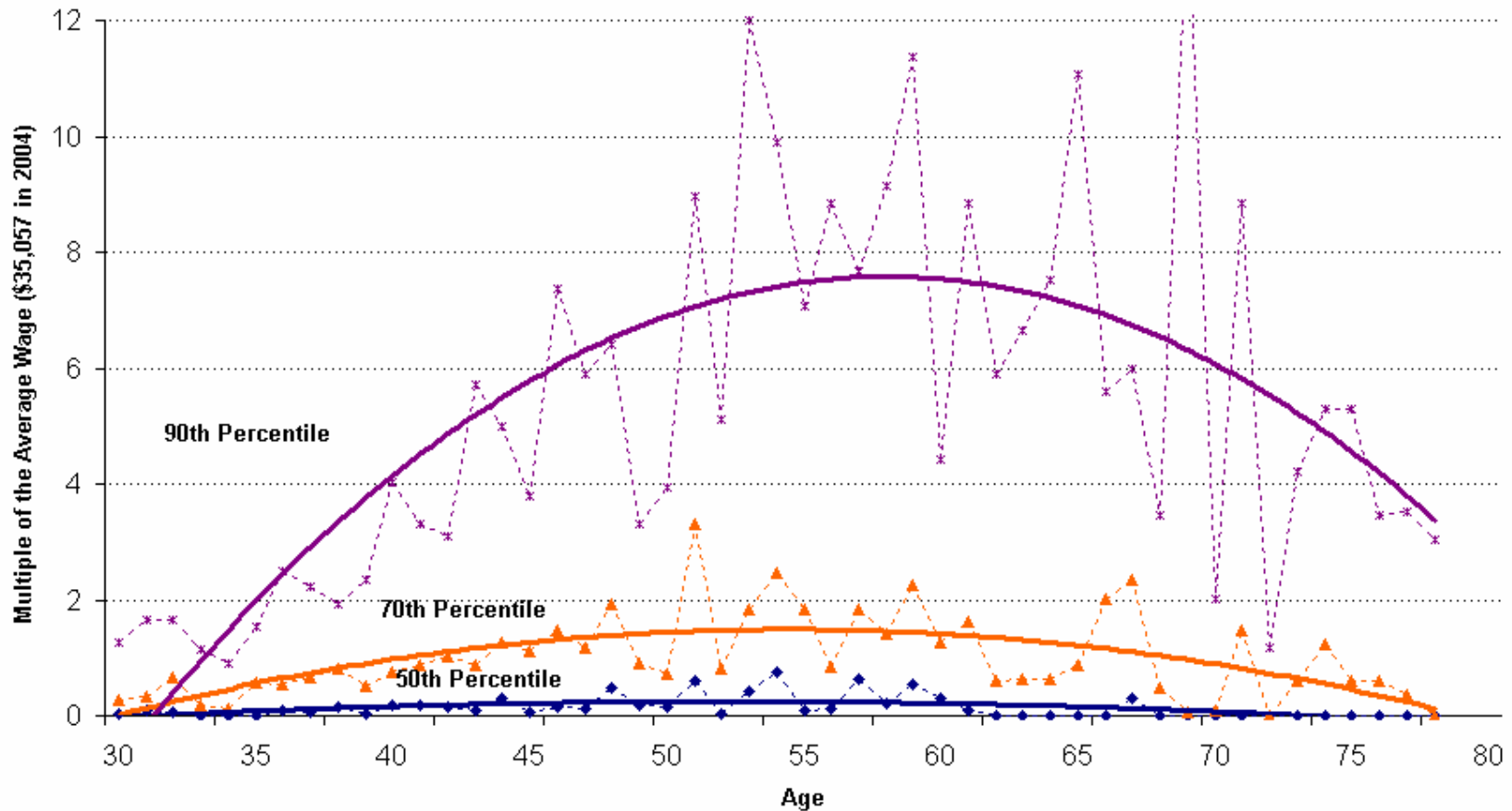
Private-sector wage and salary workers, ages 25 to 64

	Full-time only	Full- and Part-time
Characteristic	Percent	Percent
Total individual income		
Top Quartile	27.5%	28.3%
Second Quartile	36.4%	45.0%
Third Quartile	48.3%	72.4%
Bottom Quartile	71.6%	90.4%
Race		
White, non-Hispanic	40.7%	45.6%
Black, non-Hispanic	50.9%	55.0%
Hispanic	67.4%	72.0%
Other	50.9%	53.5%
Marital Status		
Married	42.8%	46.8%
Single	56.1%	59.5%
Education		
Some high school	74.2%	76.6%
High School graduate	52.1%	55.7%
Some College	47.0%	51.8%
College graduate	36.4%	40.0%
Firm size		
Fewer than 25 employees	72.8%	82.7%
25-99 employees	50.2%	56.5%
100 or more employees	32.4%	37.8%
Age in years		
25-34	54.3%	59.8%
35-44	45.6%	48.9%
45-54	40.1%	43.3%
55-64	41.8%	46.8%
All workers	45.9%	74.7%

Source: The Urban Institute, 2004. Based on data from Patrick J. Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends." CRS Report for Congress, September 2004; and original data from the Current Population Survey, various years.

FIGURE 4

Ratio of Retirement Account Balances to Average Earnings by Age and Income Percentile
(Median Income is the 50th Percentile)



Notes: Average earnings as reported by the Social Security Administration; present value of defined benefit accounts are not included in the retirement account balances. Source: Urban Institute cross-sectional tabulations of the 2001 Survey of Consumer Finances.

FIGURE 5

Types of Pension Plans Under Current Law

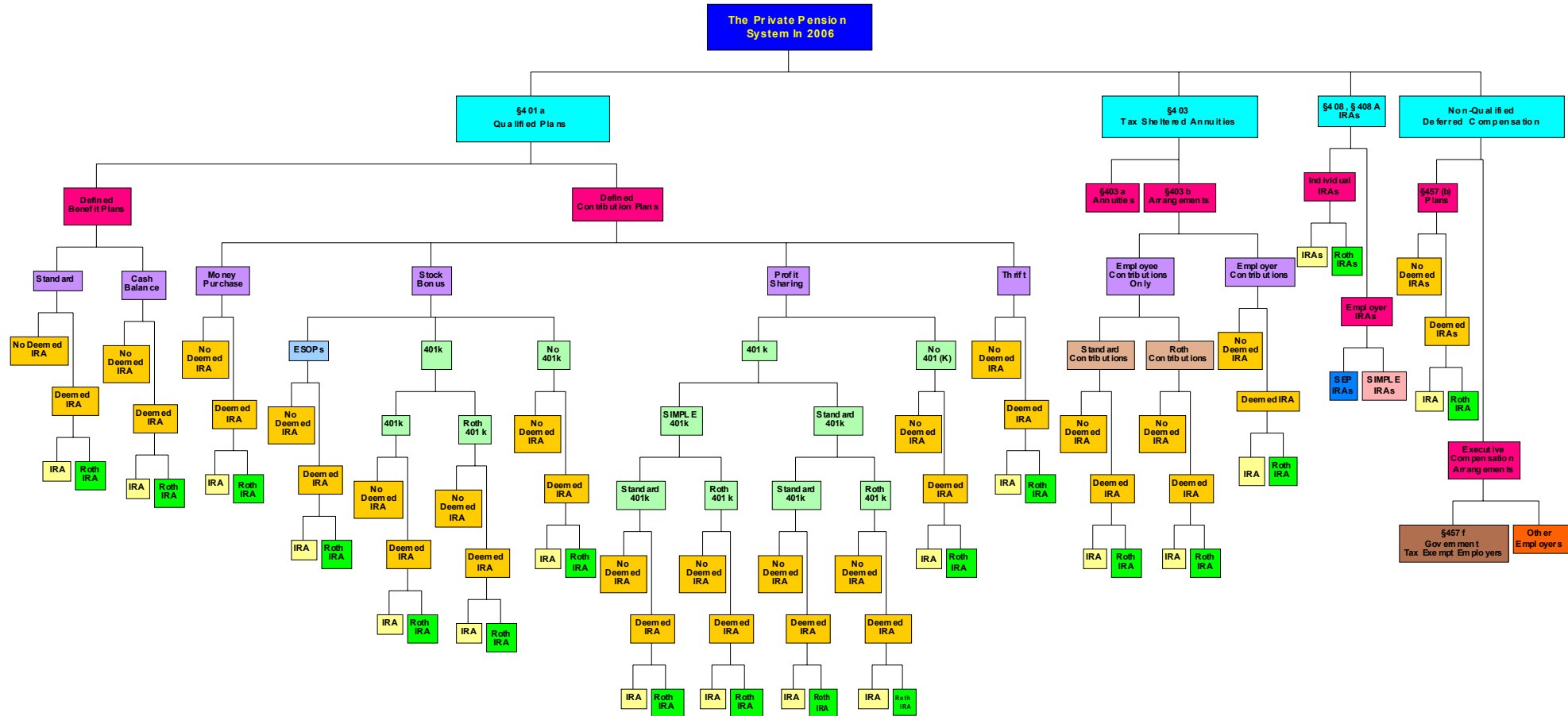
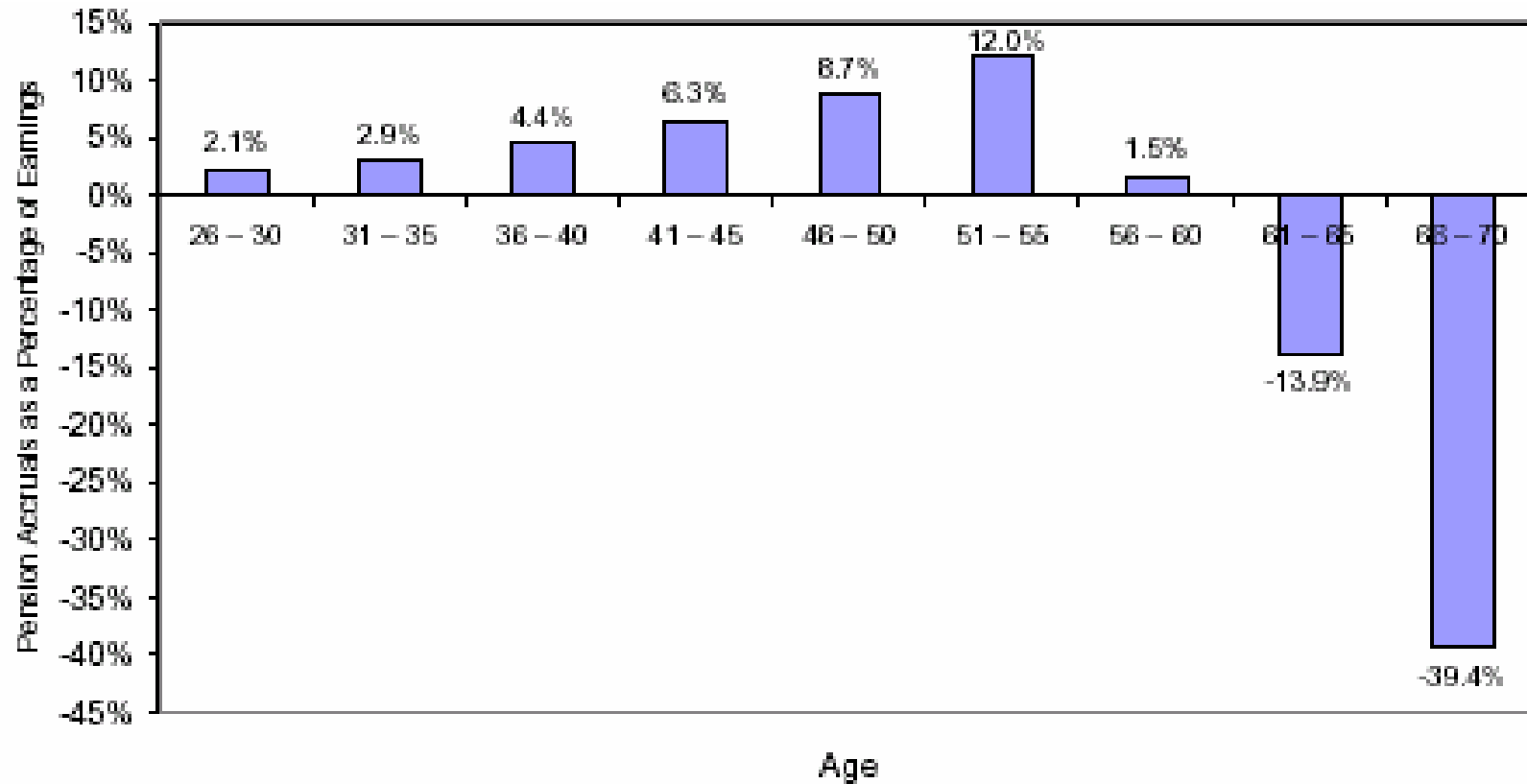


FIGURE 6

**Average Accruals in Private Defined Benefit Plans, 2002
(For Workers Starting at Age 25)**



Note: The analysis is based on a sample of 340 salary-based defined benefit plans in the private sector. Accrual estimates assume that workers join the firm at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that inflation is 3.3% and that real interest is always 3% above inflation. Estimates are weighted by firm size.

Source: From Rudy Penner, Pamela Perun and C. Eugene Steuerle. "Legal and Institutional Impediments to Partial Retirement and Part-time work by Older Workers." Washington DC: The Urban Institute, November 20, 2002. Available at <http://www.urban.org/url.cfm?ID=410587>.